VIEWPOINT

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# Newsflash

A new month and the 53rd issue of Viewpoint from FP.

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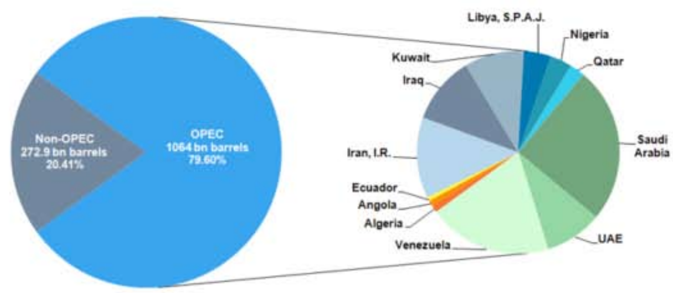
The headlines for the month of February were dominated by the growing geopolitical tensions throughout the Middle East and North Africa region (MENA). Tunisia is perhaps best known as a Western friendly state, with a diverse and relatively successful economy and is not a country that one would associate with the forefront of a movement that is rapidly turning from protests of disgruntled poor to a potential revolution of the oppressed. Egypt's regime was the second to topple as the ruling few could not escape the inevitable end of their tenure. Other states located nearby have now started to feel the mumblings of discomfort from the general public, with Bahrain's tensions sufficient for the inaugural Formula 1 race of 2011 at the country's International Circuit to be cancelled. Other states where troubles have flared include Yemen and, more worryingly, Iran. It is Libya's troubles, however, which are causing the greatest concern to commentators globally. The Libyan leader, Muammar Gaddafi, knows well that the key to power is maintaining the military's loyalty, having come to power behind a phalanx of tanks during the bloodless coup of 1969. Presently, despite some high profile desertions, including two jet fighters that landed in Malta, Gaddafi seems to have kept the majority of the military at least outwardly sympathetic to his regime. Despite this, the rebels appear to control much of the country, but Gaddafi has confirmed his intention to fight "to the death" or "to the last man", which, combined with his military posturing and the use of hardware already, should not be treated as simply an idle threat. Despite growing unrest, presently most of the international community appears willing to treat this as a domestic issue for Libya, with the UN remaining cool about the prospect of military intervention despite accusing Libya of committing gross violations of human rights. UK Prime Minister David Cameron has mooted the possibility of creating a 'no fly zone' over Libya, to prevent the use of aircraft against civilians, but this is not necessarily an attractive option for the Libyans, with Gaddafi claiming "We will not accept [an] American intervention. This will lead to a bloody war and thousands of Libyans will die if America and NATO enter Libya".

**OPEC Share of World Crude Oil Reserves 2009**




OPEC proven crude oil reserves , end 2009
(billion barrels)

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Saudi Arabia | 264.59 | 24.9% | Iraq | 115.00 | 10.8% | Libya, S.P.A.J | 46.42 | 4.4% | Algeria | 12.20 | 1.1% |
| Venezuela | 211.17 | 19.8% | Kuwait | 101.50 | 9.5% | Nigeria | 37.20 | 3.5% | Angola | 9.50 | 0.9% |
| Iran, I.R. | 137.01 | 12.9% | UAE | 97.80 | 9.2% | Qatar | 25.38 | 2.4% | Ecuador | 6.51 | 0.6% |

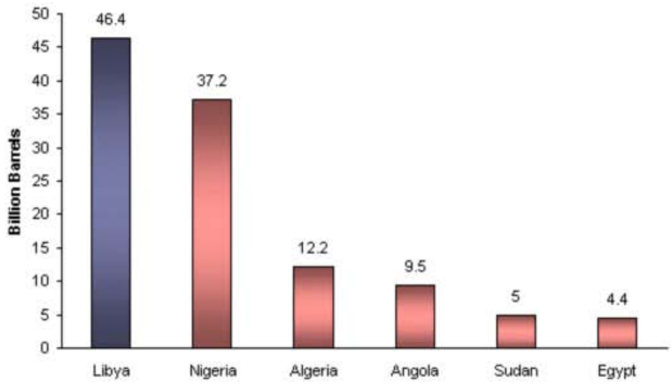
*Source: OPEC Annual Statistical Bulletin 2009*

The oil price has increased as a result of this unrest. According to the US Energy Information Administration, Libya holds the largest proven oil reserves in Africa. From a global perspective, however, the impact on the oil price should remain relatively low as Libya's reserves are a slender 4.4% of OPEC's total reserves. The rise in the oil price of late is, therefore, based both on Libya's unrest, but also contains an increased risk premium on the basis that this crisis escalates in such a way that imperils global oil supplies in a more fundamental manner.

Despite the rising spectre of conflict, February proved to be a positive month for risk assets. Global developed equity markets, gained 3.5% in US Dollar terms. In local currency terms the returns from the Japanese market were strongest, with a February gain of 4.6% in yen terms for the Topix. The S&P 500 added 3.4% in USD terms, whilst the UK and Europe gained 2.4% and 2.0% in their respective currencies. The global emerging markets index continued its recent underperformance compared to the developed markets, with a return of -0.9% in US Dollar terms. This is the result of a number of factors, including a growing belief that these markets have become overvalued of late and the likely impact of the recent turmoil in the MENA region on these economies. Year to date the underperformance is relatively significant, with the emerging markets having produced returns of -3.6% compared to a developed market gain of 5.8% over the same period.

The fixed income markets produced moderate positive returns with the Citigroup World Government Bond Index gaining

**African Proven Oil Reserve Holders, 2011**




Source: Oil and Gas Journal

0.4% in February and the World Broad Investment Grade index outperforming by a small margin, with a return of 0.5%. Credit produced stronger returns than government paper, which can be extrapolated for the high yield markets, with, for example, the US high yield market returning 1.3%. Interestingly, whilst the GEM equity market posted losses for February, the emerging markets bond index did not rally especially, with the index gaining 0.2% in US Dollar terms. Convertible bonds benefitted from the equity market rally, with a gain of 2.1% in February representing 60% of the month's global equity upside.

Despite some strong regional performances, the global property securities market underperformed the broader global equity market in February with a return of 2.6%. This sector of the equity markets has also underperformed year to date, with a return of 3.9%, compared to 5.8% from global equity over the same period. From a regional perspective, most property security indices performed well, with the UK's index gaining 8.3% in Sterling terms for the month. The US also performed well, with a gain of 4.5% in February, whilst mainland Europe returned 3.2% in euro terms. The Asian region underperformed, however, with

*Source: RMB Asset Management / Bloomberg. March 2011. Past performance is not indicative of future returns.*

a return of -0.8% in euro terms. Year to date the US and UK are the strongest regional property securities markets, with gains of 7.9% and 7.2% in their respective local currencies. These return differentials again highlight the diversity in returns between regional property markets.

In the currency markets, the US Dollar weakened slightly against most majors in February. Commodity currencies such as the Australian Dollar and South African Rand performed well on the back of commodity price increases. February's gains of 2.1% for the Australian Dollar and 3.5% for the South African Rand against the greenback provided some respite for these currencies, which remain weak year to date, with the Rand having slipped -4.7% by the end of the second month. The yen has also suffered slightly year to date, depreciating by -1.0%, all of which came in January as the Japanese currency was flat versus the US Dollar in February. Turning to Europe, both the euro and Sterling were stronger in February, with gains of 0.8% and 1.6% respectively that brings year to date returns to 3.0% and 3.9% for the two currencies compared to USD.

The commodities markets were generally strong in February. The Rogers Broad Commodity Index gained 3.9% during the month, to bring its year to date gains to 7.2%. This year to date return is effectively mirrored by the agriculture carve-out, which has gained 7.3% over the same period. In February, however, agricultural commodity futures gained 1.5%. Gold's 6.3% rally over the same period appears to be on the back of growing anxiety relating to the crisis in the Middle East and African regions. In February Brent crude gained 14.2%, continuing its recent strong run. The oil price was already relatively elevated before these recent geopolitical tensions and this means that the inflationary influence of oil continues. Indeed, the year to date gain for Brent is 20.0%. Much of the unrest in the MENA region may be aimed at totalitarian regimes and dictatorships, but the catalyst for the unrest is more likely to be the recent increases in consumer prices. Last year agricultural commodities rose 36.3% and oil gained 20.1%. The cost of food is particularly important in the less economically developed world due to the fact that it is this portion of the commodities market that forms a larger component of the consumption basket. Oil and other energy costs are understandably also significant and therefore a number of emerging economies with potentially disharmonious populations are likely to be making moves to curb inflation wherever possible. Indeed, China's latest five year plan appears to sacrifice some top line growth in favour of a higher quality of growth, the benefits of which should spread more evenly throughout society.

*Source: RMB Asset Management / Bloomberg. March 2011.*

## Asset Class Performances

| Asset Class/Region | Index | Currency | Feb 2011 | YTD 2010 |
|---|---|---|---|---|
| **Equities** | | | | |
| **United States** | S&P 500 NR | USD | 3.4 | 5.8 |
| **United Kingdom** | FTSE All Share TR | GBP | 2.4 | 1.9 |
| **Continental Europe** | MSCI Europe ex UK NR | EUR | 2.0 | 4.8 |
| **Japan** | Topix TR | JPY | 4.6 | 5.9 |
| **Asia Pacific (ex Japan)** | MSCI AC Asia Pacific (ex Japan) TR | AUD | -1.7 | -1.9 |
| **Global** | MSCI World NR | USD | 3.5 | 5.8 |
| **Global Emerging Markets** | MSCI World Emerging Markets TR | USD | -0.9 | -3.6 |
| **Bonds** | | | | |
| **US Treasuries** | JP Morgan United States Government Bond Index TR | USD | -0.1 | -0.1 |
| **US Treasuries (inflation protected)** | Barclays Capital U.S. Government Inflation Linked TR | USD | 0.9 | 1.0 |
| **US Corporate (investment grade)** | Barclays Capital U.S. Corporate Investment Grade TR | USD | 0.8 | 1.0 |
| **Us High Yield** | Barclays Capital U.S. High Yield 2% Issuer Cap TR | USD | 1.3 | 3.6 |
| **UK Gilts** | JP Morgan United Kingdom Government Bond Index TR | GBP | 0.8 | -1.2 |
| **UK Corporate (investment grade)** | Merrill Lynch Sterling Non Gilts TR | GBP | 1.0 | 0.4 |
| **Euro Government Bonds** | Citigroup EMU GBI TR | EUR | 0.0 | -0.5 |
| **Euro Corporate (investment grade)** | Barclays Capital Euro Aggregate Corporate TR | EUR | 0.8 | 0.4 |
| **Euro High Yield** | Merrill Lynch Euro High Yield 3% constrained TR | EUR | 1.9 | 4.4 |
| **Australian Government** | JP Morgan Japan Government Bond Index TR | AUD | -0.1 | -0.8 |
| **Japanese Government** | JP Morgan Japan Government Bond Index TR | JPY | 0.3 | 1.2 |
| **Global Government Bonds** | JP Morgan Global GBI | USD | 0.4 | 0.3 |
| **Global Bonds** | Citigroup World Broad Investment Grade (WBIG) TR | USD | 0.5 | 0.8 |
| **Global Convertible Bonds** | UBS Global Convertible Bond | USD | 2.1 | 3.9 |
| **Global Emerging Market Bonds** | | USD | 0.2 | -0.4 |

*Source: RMB Asset Management / Bloomberg. March 2011.*

| Asset Class/Region | Index | Currency | Feb 2011 | YTD 2010 |
|---|---|---|---|---|
| **Property** | | | | |
| **US Property securities** | MSCI US REIT TR | USD | 4.5 | 7.9 |
| **UK Property securities** | FTSE EPRA/NAREIT United Kingdom TR | GBP | 8.3 | 7.2 |
| **Europe ex UK Property securities** | FTSE EPRA/NAREIT Europe ex UK TR | EUR | 3.2 | 1.5 |
| **Asia Property securities** | FTSE EPRA/NAREIT Asia TR | USD | -0.5 | -1.0 |
| **Australian Property securities** | FTSE EPRA/NAREIT Australia TR | AUD | 5.2 | 4.9 |
| **Global Property securities** | FTSE EPRA/NAREIT Global TR | USD | 2.6 | 3.9 |
| **Currencies** | | | | |
| **Euro** | | USD | 0.8 | 3.0 |
| **Sterling** | | USD | 1.6 | 3.9 |
| **Yen** | | USD | 0.0 | -1.0 |
| **Australian Dollar** | | USD | 2.1 | -0.7 |
| **Rand** | | USD | 3.5 | -4.7 |
| **Commodities** | | | | |
| **Commodities** | RICI TR | USD | 3.9 | 7.2 |
| **Agricultural Commodities** | RICI Agriculture TR | USD | 1.5 | 7.3 |
| **Oil** | ICE Crude Oil CR | USD | 14.2 | 20.0 |
| **Gold** | Gold index | USD | 6.3 | 0.0 |
| **Interest rates** | **Last meeting** | | **Current rate** | **Change at meeting** |
| **United States** | 26 January 2011 | USD | 0.25% | No change |
| **United Kingdom** | 10 February 2011 | GBP | 0.50% | No change |
| **Eurozone** | 03 March 2011 | EUR | 1.00% | No change |
| **Japan** | 14 February 2010 | JPY | 0.10% | No change |
| **Australia** | 01 March 2011 | AUD | 4.75% | No change |
| **South Africa** | 10 March 2011 | ZAR | 5.50% | No change |

*Source: RMB Asset Management / Bloomberg. March 2011.*

## Focus: Is there value in the US equity market?

As is often the case, equity market movements have recently been driven by shorter term sentiment with investors focusing on unrest in the Middle East or the debt problems of peripheral Europe. Commentators have frequently dubbed this somewhat myopic environment as being a 'risk-on, risk-off' market suggesting that more attention is being given to these factors that impact short term sentiment rather than focusing on the longer-term within the framework of a clearly defined investment philosophy. Of the frameworks or investment philosophies available to investors, valuation is the most researched, most widely used and is also intuitively sensible: adhere to a predefined method for determining value and then aim to buy low and sell high. Numerous academic studies have verified that differences in standard valuation measures have a meaningful impact on long term returns, and so investors should never lose sight of valuations, at both the individual stock and broad market levels. This month Focus will examine the US equity market and consider whether, at current levels, the S&P 500 (S&P hereon) offers value to long term investors. This market cap weighted index represents the largest 500 listed companies in the United States and – since companies in the US represent almost half of the MSCI World index – this analysis is also very relevant for global equity investors. In early March two years ago the S&P closed at a low of 676 around the depths of the credit crisis. Since then the index has rallied by over 95% (to 1327 at the end of February 2011) representing one of the biggest two year price return periods seen over the last 80 years; only gains in the two year periods ending July 1934, March 1937 and September 1955 have exceeded this. At first glance there are plenty of reasons to be cautious on the US market, including evidence of weak employment growth, tighter regulation and the risk of a double-dip recession, and so the magnitude of the rally over the past two years may be causing investors to worry that valuations are now overstretched. This, therefore, is a good juncture at which to make an objective analysis of valuations as determined by fundamentals.

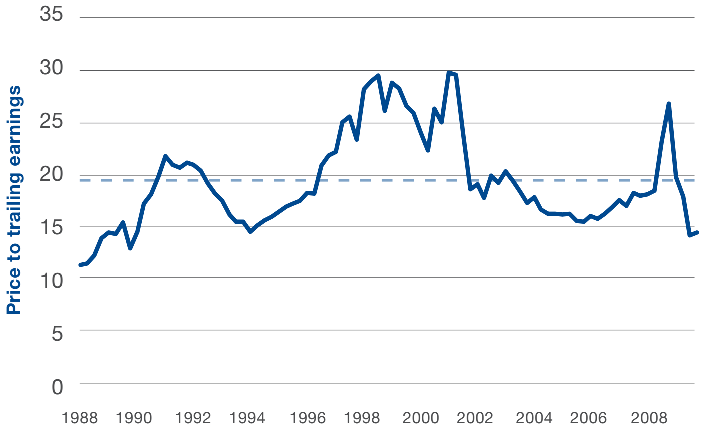
There are a number of valid approaches to valuing equity investments which can generally be applied at either the individual stock level or at the aggregate index level (i.e. S&P) given increased data availability in recent decades. There is however less data available for markets outside of the US and since most standard measures of valuation are backward looking it is somewhat harder to confidently make an assertion of value in markets where there is only 10 or 20 years of data available. Even forward looking measures of valuation, such as discounted cash flow or dividend discount models, typically include assumptions about future variables such as margins that are largely predicated on historical averages. No single valuation measure is superior to others – there is no 'magic' ratio and different practitioners have different views over which works best or utilise a variety of approaches. However, as with most forms of statistics, valuation data can be highly malleable and interpretations can depend to a large extent on one's world view, the time period used and underlying assumptions.

The most frequently used valuation measure is the ratio of price to earnings, or P/E ratio. This measures the current price as a multiple of either trailing 12 month earnings for a company or expected earnings over the next 12 months. This approach is inherently sensible given that earnings power, as measured by earnings per share, is a primary determinant of investment value. The use of either trailing or forward earnings can make a meaningful difference though and there are various advantages and drawbacks to each. Using trailing earnings is usually simpler since it is based on readily available data on actual realised earnings, but suffers the disadvantage of not being able to incorporate factors that will have a meaningful impact on earnings in the future. For example, on a trailing P/E basis the market may look expensive when earnings are expected to expand substantially from depressed levels, such as in mid-2009. The use of forward earnings gets around this problem, but this method is less useful if earnings are expected to be very volatile making next year difficult to forecast. Also when looking at forward earnings at the index level, most investors will have to rely on consensus expectations from sell side analysts as it is too onerous to produce independent forecasts for all constituents. Given the propensity for sell side estimates to be overly optimistic at the top of the economic cycle, or overly pessimistic at the bottom, there is the risk that forward P/E ratios based on consensus expectations may be misleading. A more general drawback for using earnings-based valuation measures is that

*Source: RMB Asset Management / Bloomberg. March 2011.*

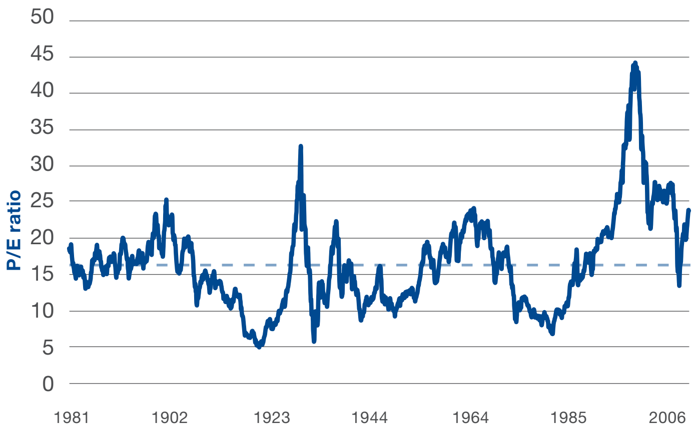
management discretion within allowed accounting practices can distort reported earnings, thus reducing comparability across firms and markets.

**S&P 500 price to trailing operating earnings**




The chart above shows the P/E ratio for the S&P based on operating earnings (which exclude nonrecurring or extraordinary items thus making them less volatile). At less than 15 times operating earnings the market is cheaper than the average over the 23 year time period used here, although this period incorporates the past two decades where P/E multiples have been unusually high and volatile, thus distorting the average significantly. Alternatively, using forecast earnings from Bloomberg, the S&P is trading on 13.8 times consensus estimated earnings as at the end of February, compared to a five year average of 14.8x. On these measures the S&P does not appear to be offering compelling value but nor does it seem to be overly expensive.

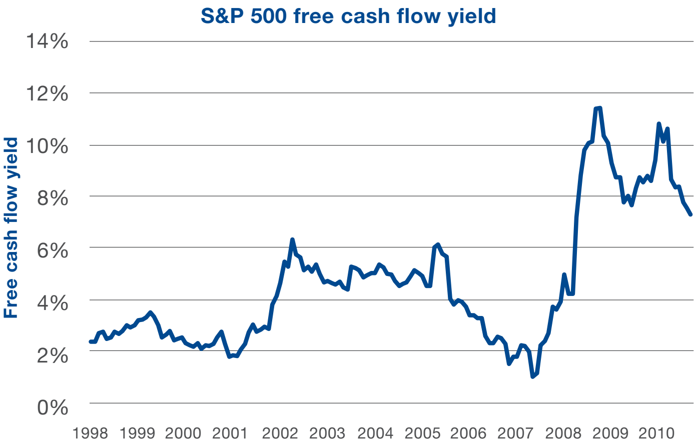
**S&P 500 Graham and Dodd P?E and Average**



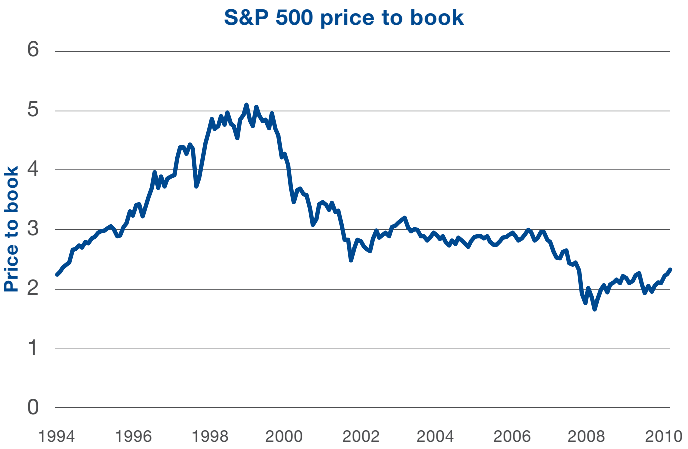

A significant drawback of P/E ratios is the volatility of earnings, particularly during and immediately after recessions. For example, following the recent recession S&P reported earnings declined by 90% sending P/E ratios above 100x. In their famous 1934 textbook, Security Analysis, Graham and Dodd suggested an approach to mitigate this problem. They said that for purposes of examining valuation ratios one should use an average of earnings of "not less than five years, preferably seven or ten years". The result of this smoothing process, based on average real earnings over the past ten years, is shown on the chart bottom left. On this basis the S&P is currently trading at 23.7x compared to an average of 16.4x, thus making the market appear relatively expensive. Unfortunately this approach is difficult to use outside of the US due to a lack of long term information for most stock markets, and with only a few decades of data it is not sensible to use a rolling ten-year horizon.

Another popular valuation method is based on free cash flow. This compares the index or stock price to the amount of cash generated, after providing for the amount required for capital expenditure and working capital. This method can be an accurate and more direct measure of value for investors since it is feasible that the firm could pay the vast majority of free cash flow out as a dividend (if the firm carried little debt), as compared to using earnings which are more of an accounting measure and do not actually represent the amount of free cash available. In this sense free cash flow (to equity) is a more relevant measure for investors to look at than dividend yield, so long as one can reliably assume that management will act in the best interests of shareholders by only reinvesting this cash in value-creating projects, and otherwise eventually returning excess cash in the form of a dividend. An advantage of this approach over a method based on accounting earnings is that free cash flow is harder for management to manipulate, and is generally more stable than earnings.

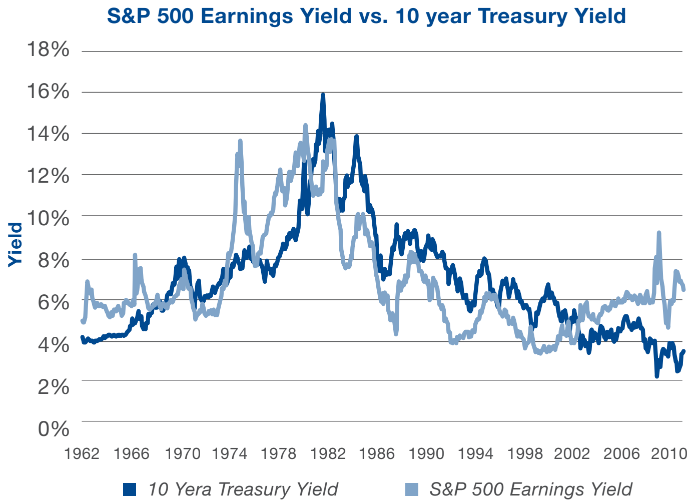
*Source: RMB Asset Management / Bloomberg. March 2011.*




The chart above shows that the free cash flow yield of the US market remains attractive compared to recent history and in fact studies over longer time periods show that yields are close to multi-decade highs. This suggests corporations are converting earnings to cash at a higher rate than they have historically, potentially as a result of better management or a lower cost of capital. Another potential explanation though is that corporations may be scarred from two sharp recessions in the last decade and have been discouraged from reinvesting in their business.




The metric of choice for asset-based valuations is typically price to book, which measures the ratio of current market price to the total balance sheet value of tangible corporate assets minus liabilities (excluding intangible assets such as brand value). This measure is less volatile than earnings and has the benefit of still being valid when earnings are negative. However, it fails to provide information on profitability and can be misleading when there are significant differences in the asset size of firms under consideration. Also, there could be significant differences between book and market value, for example due to inflation. The S&P currently trades at 2.3x book value, which is relatively high compared to the post 1927 average of 1.6x, although this average increases to 2.0x if one only includes environments of moderate inflation (consumer price inflation between 1-4%).




Another way to think about valuation is in a more relative sense, such as by comparing the yield provided by equities to the yield from an alternative investment like bonds. The chart above compares the earnings yield for the S&P (the reciprocal of the P/E ratio) to the yield on ten year US Government bonds which are typically deemed to be 'risk free'. The logic behind this comparison is that investors should buy the assets that offer the greater yield: currently equity yields are substantially higher than those for bonds, by a margin that is close to being the greatest for 50 years. If the yields were closer together in most cases investors should still favour equities because equities have a sizeable advantage over government bonds that over time should outweigh the additional risk: unlike bonds they can display pricing power, thus providing inflation protection and the potential for long term real growth in earnings or cash flow.

Having looked at a variety of valuation measures it is clear that each tells a different story. Valuations certainly seem less attractive on a P/B basis compared to a P/E basis, reflecting the fact that across the market returns on equity (ROE) are currently higher than historic averages. This improvement in returns has been driven by increasing efficiency and margins, with these

*Source: RMB Asset Management / Bloomberg. March 2011.*

two factors recently outweighing the impact of deleveraging which reduces ROE. Over the last 20 years ROE for the S&P has consistently been at the high end of its historic range and some would argue that this is for structural reasons such as a lower cost base and better management. However If one expects labour and capital costs to rise then ROE is likely to revert back to the longer term average and the use of P/B as a valuation indicator would be appropriate. The cyclically adjusted P/E based on ten year average earnings also appears high at this juncture, although some may argue that two sharp recessions in the past decade, coupled with the current abnormal interest rate environment, make this measure less relevant than it has been in the past. Alternatively, valuations do not look excessive on a trailing or forward P/E basis, whilst absolute cash flow yields and earnings yields relative to bonds look positively compelling at present. The S&P appears to be cheap relative to Treasuries, although to believe this requires belief that current earnings are sustainable.

Ultimately Focus thinks that there is still scope for US equities to move higher during the current economic upswing, but at current levels valuations are certainly vulnerable to inflation surprises or disappointing earnings. In the near term, if the nascent economic recovery remains on track and inflation expectations remain stable, then historic valuation measures may not matter. The success or failure of the second round of quantitative easing in the US could have a significant impact on market valuations in the coming years. However, over the longer term one would expect valuation levels to have a greater influence over returns. Although there may be special circumstances that will change the historical relationship between valuations and subsequent returns, it is important to remember that there have always been ‘special circumstances’ that investors could point to and these should not be raised as a reason to ignore valuation measures.

*Source: RMB Asset Management / Bloomberg. March 2011.*

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